



TD Economics

Observation

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REAL WORK REMAINS TO REPAIR THE GLOBAL ECONOMY

The global economy continues to dig itself into a hole that will take years to climb out of. The Eurozone economy contracted by 1.5% in the last quarter of 2008 and looks to have contracted by a bit more in the first three months in 2009. The Brazilian economy shrank by 3.6% in the final quarter of 2008 and likely a further 1.5% from January to March. Only China, the lone major economy to grow in the final quarter of 2009, may announce later this month that year-over-year GDP growth accelerated noticeably from its 6.8% pace at the end of last year.

In a forum typically regarded as providing more pomp and circumstance than practical results, the G-20 last week was appropriately lauded as providing more substance than expected. Perhaps most surprising was the air of compromise and inclusiveness. However, much of this compromise came on issues – such as the size of IMF resources and the voice of emerging markets – that have raged in international policy circles for over a decade. This newfound willingness to compromise must now be extended to the issues plaguing this decade and the next.

New IMF financing is a good start...

The G-20 announced that total IMF resources would be tripled from \$250 billion to \$750 billion. Over the last 60 years, the size of the global economy has grown twice as fast and global trade flows three times as fast as the size of the IMF's resources, so this helps to restore some of the relative influence of the IMF. In fact, this represents an even larger increase in the resources of the IMF which are available to be lent out to emerging markets in the next couple of years. After accounting for the money the IMF has already lent out or is committed to provide, they had less than \$140 billion remaining as of March. So this decision provides five times more financing available to be lent out in the near term. Should the IMF require more capital

HIGHLIGHTS

- **There were three important developments from last week's G-20 meeting: more IMF financing, a greater voice for emerging markets, and the ongoing commitment to reform the global financial architecture.**
- **But nothing has required a change to our dour global economic forecasts.**
- **For example, nothing has diminished Eastern Europe's financing needs, but at least now we know the IMF has the funding to provide.**
- **Going ahead, you can't fight what you can't see so regulatory changes which shine a light on capital flows are greatly needed.**
- **But financial crises, like history, never repeat but always rhyme.**
- **Regulatory reform therefore must focus on future vulnerabilities, like the fiscal extremes that will bear close attention, and not simply create yet another Maginot Line.**

beyond this, they will consider issuing their own SDR-denominated debt. This option has been under review recently with the general opinion that this debt could be sold to official sources under the IMF's existing rules, but legal revisions would be needed before the IMF could issue this debt to private markets. Moreover, the IMF will sell about 6% of their existing gold holdings to finance lending on concessional terms to the poorest nations.

...But the need for financing was already large...

However, the need for IMF financing is already very large. The IMF has estimated that emerging markets have a minimum need for tapping capital markets for several

hundred billion dollars each of the next two years and Emerging European economies as a whole represent a significant portion of this. As such, much of this new money is already loosely earmarked. Eastern Europe still has the same sizeable financing need, but after last week, we know the IMF will be the one providing the money. In addition, the IMF recently created a new financing facility, called the Flexible Credit Line, which can provide financing in much larger sums and much faster than was previously possible. But as this financing is for larger emerging markets – such as Mexico which has already said it plans to draw as much as \$47 billion – the additional funds provided to the IMF could be quickly lent out.

...and IMF financing is not, strictly speaking, stimulus

None of this money is economic stimulus in the same sense as fiscal spending. When a government pledges to increase the benefits being paid to the unemployed, for example, this is money which the government borrows and spends in order to serve as a partial offset to the reduced spending of the private sector. IMF lending is a different beast. First off, IMF financing is forbidden from being used for domestic fiscal purposes and instead is provided for what is called balance of payments issues. This means when an economy finds itself with a sudden need for foreign currency beyond its own reserves, their two options to address this are either to borrow the foreign currency needed or drastically reduce imports, which in turn means a sharp contraction in domestic spending in the economy. IMF financing thus does reduce the need for domestic adjustment, but it is not strictly speaking stimulus spending. It does lessen the costs for the worst hit emerging markets, though, and as such, can benefit all nations who are interconnected through trade and financing linkages.

Secondly, while member governments will typically have to borrow by issuing their own debt in order to provide this new funding to the IMF, this funding is provided as a loan. As such, creditor governments earn a return on their money. Moreover, the IMF is considered a “super senior” creditor, meaning that should the nations borrowing from them default on their debts, the IMF is repaid first. Through history, IMF loans have therefore always been repaid and are typically considered risk-free investments on the part of member nations so those providing the IMF with funding need have no set-aside provisions for loan losses. But the \$500 billion in IMF support is a combination of new money, old money, and still-to-be approved money. Canada

has pledged \$10 billion in additional financing which can be immediately provided. \$100 billion is money Japan had already agreed to provide the IMF in February. And, the U.S. has promised to provide \$100 billion once a decade-old credit line (the New Arrangements to Borrow) is updated, but will require Congressional approval and a likely open debate in Congress on hot-button topics such as global imbalances and the value of the Chinese renminbi.

Other financing provided to support trade

There is also \$100 billion announced for lending from other Multilateral Development Banks, such as the Inter-American Development Bank, but this does not appear to be new money but a commitment to lend out existing funds. In addition, \$250 billion will be spent both through these organizations as well as domestic export credit agencies. This can help address the rapid collapse in global trade flows by ensuring adequate financing, but once again, this money is not stimulus spending.

...But the commitment to free trade was time sensitive

One odd feature in the Leaders’ Statement was the commitment “to refrain from raising new barriers to investment or to trade in goods and services imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures...to the end of 2010.” Given free trade is of great benefits to all parties in reducing costs for consumers and the level of production for producers, especially when it is not distorted through tariffs, quotas, and other trade barriers, they should have committed to this beyond the next 21 months. Or better yet, there could have been a commitment to an imminent reduction of trade barriers or more than a token mention of remaining committed to the Doha round of trade negotiations. There was also a mention of minimizing the negative impact of fiscal policy on international trade or investment. This seems to soften the impact of this pledge even more and suggests some protectionism will still be acceptable as long as it is cloaked in the mantle of domestic fiscal stimulus. It is unfortunate the commitment to free trade was not more resolutely reaffirmed.

The end of regulation without representation?

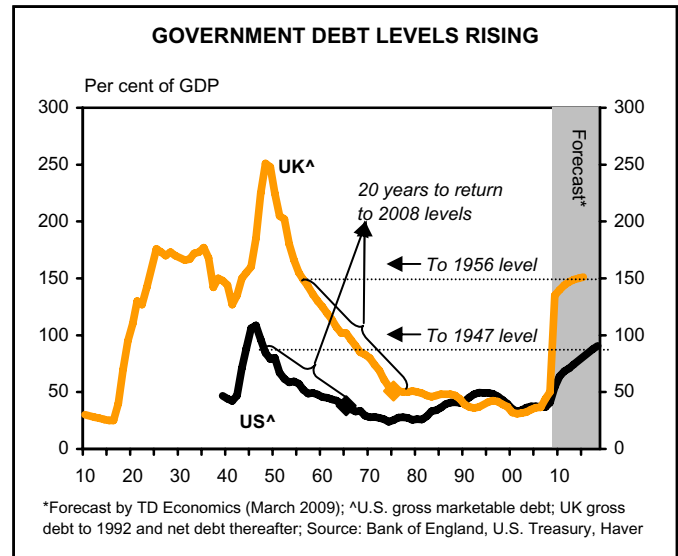
Emerging markets have for some time seen their voice in the global community fall far short of their growing importance to the global economy. Significant steps were taken to start addressing this. The announcement of a general SDR allocation of \$250 billion has been an issue raised among emerging markets for over a decade, and

was particularly amplified in recent weeks with calls from Russia and China to reduce the importance of the U.S. dollar (see *Why China Wants to Dump the Dollar*: http://www.td.com/economics/special/rk0309_china.pdf). Once again, this is a financing issue, not a fiscal stimulus measure, which will allow for easier conversion of international reserves into an asset which may hold its value better than any single currency. Along with the decisions to increase the voting share of emerging markets in the IMF by January 2011, and to break with tradition that an American always leads the World Bank and a European always leads the IMF, there was progress in rebalancing emerging market's voices. One reason for the global imbalances that have accumulated in recent years has been that emerging markets have increasingly operated outside of the established global financial system and no lasting solution will be possible if they are not given a real voice.

The changes still to come

Increasing the voice of emerging markets and reforming the regulatory environment have two things in common. Both will play little role in solving the current problems, but are crucial for creating sustainable economic growth in the future. Tracking global capital flows now is akin to trying to manage your household finances with no clear knowledge of when your paycheck and bills are paid or what size they are, but everything is paid automatically. You simply have to hope that nothing goes wrong. Obviously, you can't fight what you can't see and large mismatches will almost certainly grow over time. On this account, the pledge to regulate hedge funds, rating agencies, and other "systemically important financial institutions, instruments and markets" could be quite effective even if it can just accomplish the admittedly difficult task of shining a light on how the money is flowing through the system.

Similarly, suggesting sanctions might be used to address tax havens could benefit the global system, as well. However, as with any regulatory change, the ultimate effectiveness will depend on the teeth of the policy, and sanctions could simply imply a strategy of "name and shame" for the guilty parties. This would be of questionable use given the issue is not knowledge of who the tax havens are, but of what they are holding. These teeth and the overall regulatory framework will be proposed over time by the renamed and empowered Financial Stability Board. The modalities of such crucial issues as countercyclical



capital buffers and limits on leverage will be a key to success, but as details are still being hashed out by the various subcommittees, this is one area where we must wait and see. But once again, as this work is much more about preventing future crises than resolving the current one, there is time – not to mention the need – to get this right.

Keeping our eyes on the prize

Financial crises, like history, never repeat, but they always rhyme. So while it is important to make sure this type of crisis never occurs again, we should not lose sight of the basic principle – any vulnerability risks being exploited. So, for example, moving forward from the current crisis where government spending is playing a vital role, we should encourage clear, impartial, and external assessments of government fiscal positions to ensure they do not become the next global liability. Early indications now are that any such reviews would be controlled by the government under review with international organizations serving only in an advisory role. International organizations must be given a free hand to raise concerns on any and all financial and economic vulnerabilities, though the ability to act will still lie with local authorities. One of the many lessons of the current crisis is that no one's best interests are served by papering over problems. After all, the first, best sign of a true problem is when it cannot stand up to the scrutiny of the light of day.

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